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Internal Revenue Service

Department of the Treasury

148.12-02

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:
CC:DOM:FI&P:5/PLR-100007-99
Date:
MAY 4 1999

LEGEND:

County =

Company =

Manager =

Bonds =

Date 1 =

Date 2 =

Date 3 =

a =

b =

Dear

This letter is in reply to your request for a ruling that investment fees paid by the County to the Company and the Manager are "direct administrative costs" which, if reasonable, may be treated as "qualified administrative costs" within the meaning of § 1.148-5(e)(2)(i) of the Income Tax Regulations.

Facts and Representations

You make the following factual representations. The Company and the Manager have entered into an agreement pursuant to which the Manager provides investment management services and the Company markets those services.

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On Date 1, the County advertised for a "Statement of Qualifications" from firms interested in serving as investment manager for the County's funds with the goal of increasing investment yield by actively trading the County's portfolio.

On Date 2, the County entered into a contract with the Manager to provide investment services to the County. Under the contract, the Manager has full discretion and authority (in accordance with the County's investment guidelines) to make all investment decisions with respect to certain of the County's funds without obtaining prior approval, and to buy, sell, or otherwise trade eligible securities.

With respect to the services provided, the Company conducts daily analysis of the County's cashflow sources and uses, and determines which of the County's investments are scheduled to mature. From this review, the County and the Company determine the assets available for investment on that day. The County and the Company then contact the Manager to review the assets available for investment and update the future cashflow requirements of the County. The Manager, with the assistance of the Company, uses this information to select investments (meeting the investment guidelines of the County) that will maximize the County's return, while allowing the County to meet its cashflow requirements. All of the security trades executed by the Manager are made through "third party" institutional traders unrelated to the Company and the Manager. Later in the day, the Company verifies that the trades have been executed and settled, and notifies the County of the same.

For these services the Company and Manager receive a fee (the "investment advisory fee") based on the average asset balance under management. The investment advisory fee is all-inclusive, containing a component for investment advice and a component for executing transactions. No additional transaction fees or sales charges are paid by the County to execute a specific trade. Neither the Company nor the Manager performs rebate tracking and reporting services for the County.

As of Date 3, the Company and the Manager were managing approximately $<u>a</u> of County funds. Of this amount, approximately $<u>b</u> are the proceeds of tax-exempt bonds, including the Bonds. The Company is a holder of the Bonds.

<u>Law and Analysis</u>

Section 103(a) of the Internal Revenue Code excludes from gross income interest on any State or local bond. Under § 103(b)(2), however, the exclusion does not apply to any arbitrage bond.

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Section 148(a) defines the term "arbitrage bond" as any bond issued as part of an issue any portion of the proceeds of which are reasonably expected, at the time of issuance of the bonds, to be used directly or indirectly (1) to acquire higher yielding investments, or (2) to replace funds that were used directly or indirectly to acquire higher yielding investments.

Section 148(b)(1) defines the term "higher yielding investments" as any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue.

Section 1.148-5 provides, in general, rules for computing the yield and value of investments allocated to an issue for various purposes under § 148. Section 1.148-5(b)(1) provides, in part, that,

> the yield on an investment allocated to an issue is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment. For this purpose, **payments** means amounts to be actually or constructively paid to acquire the investment, and **receipts** means amounts to be actually or constructively received from the investment, such as earnings and return of principal.

Section 1.148-5(e)(1) provides that, except as otherwise provided,

> an allocation of gross proceeds of an issue to a payment or receipt on an investment is not adjusted to take into account any costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment (**administrative costs**). Thus, these administrative costs generally do not increase the payments for, or reduce the receipts from, investments.

Section 1.148-5(e)(2)(i) provides that,

> in determining payments and receipts on nonpurpose investments, qualified administrative costs are taken into account. Thus, qualified administrative costs increase the payments for, or decrease the receipts from, the investments. Qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but not legal and accounting fees, recordkeeping, custody, and similar costs. General overhead costs and similar indirect costs of the issuer

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such as employee salaries and office expenses and costs associated with computing the rebate amount under § 148(f) are not qualified administrative costs. In general, administrative costs are not reasonable unless they are comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds.

It is useful to review the relevant history of § 1.148-5(e)(2). On May 15, 1989, regulations (the "1989 regulations") under § 148(f) were published in proposed and temporary form. The principal objective of the 1989 regulations was to present detailed computational rules for calculating rebate. The 1989 regulations provided that the price paid for an investment shall not be increased by brokerage commissions, administrative expenses, or similar expenses.

In January 1992, proposed regulations were issued that permitted direct administrative costs to be taken into account for determining payments and receipts on investments held by commingled funds. The preamble to these regulations stated that the exception was included to simplify "commingled fund accounting by permitting commingled funds to pass through net income to investors without `grossing up' income to reflect qualified administrative costs of the commingled fund." Direct administrative costs were defined to include audit, safekeeping, custody, brokerage, recordkeeping, and similar costs.

In May 1992, final regulations (the "1992 regulations") were issued. These regulations responded to comments received on the proposed regulations by providing that all reasonable administrative costs for investments in regulated investment companies and certain commingled funds could be taken into account. Administrative costs were defined in the 1992 regulations as including "costs paid by or on behalf of an issuer for brokerage or selling commissions, legal and accounting fees, investment advisory fees, recordkeeping, safekeeping, custody, and similar costs and expenses of a fund." There was no requirement in the 1992 regulations that the costs be direct to be taken into account.

In November 1992, proposed regulations were issued to consolidate and simplify the existing arbitrage and rebate regulations. These regulations provided that reasonable, direct administrative costs could be taken into account in computing yield and rebate for all nonpurpose investments. No list of examples of direct administrative costs was provided.

The current regulations provide one rule for investments in regulated investment companies and certain commingled funds, and another rule for other nonpurpose investments. For regulated investment companies and certain commingled funds, all reasonable administrative costs, even if indirect, are taken into account. For other nonpurpose investments, only reasonable, direct administrative costs are taken into account. As noted above, the current regulations provide examples of those costs that can be qualified administrative costs and those that cannot.

Based on this history, it can be concluded that the regulations were drafted, in part, to acknowledge the accounting problems raised by requiring a breakdown of administrative costs associated with regulated investment companies and certain commingled funds. The regulations, however, do not acknowledge a similar accounting problem for other nonpurpose investments. For other nonpurpose investments, the current regulations mandate that administrative costs be broken down. If a fee includes both a brokerage fee and an impermissible fee, such as an accounting fee, the brokerage fee is not permitted to be taken into account unless it is separately stated.

The regulatory history also supports the conclusion that the current regulations permit only a very narrow category of costs to be taken into account for nonpurpose investments that are not investments in a regulated investment company or certain commingled funds. The current regulations provide a more limited list of direct costs that can be taken into account than was provided in the January 1992, proposed regulation. Also unlike the prior regulations, the current regulations provide that brokerage and selling commissions (or similar costs) must be separately stated. We conclude that only costs that are directly connected to the buying and selling of investments are permitted costs.

In the instant case, the investments are not investments in a regulated investment company or a commingled fund. Accordingly, the investment advisory fee may be taken into account only if it is a cost such as a separately stated brokerage or selling commission.

The taxpayer argues that the investment advisory fee is similar to a brokerage and selling commission. It argues that investment advice is inherent in most brokerage commissions and that it would be impossible to determine how much of the brokerage commission is associated with investment advice. This case does not require us to decide whether an issuer can never take investment advice into account as part of a separately stated brokerage commission.

Here, the contract provides the Manager with broad portfolio management responsibilities. The Company conducts a daily analysis of the County's cashflow sources and uses, and the investments scheduled to mature. After reviewing the County's assets available for investment and the County's future cashflow requirements, the Manager and Company select investments (that meet the investment guidelines of the County). All security trades are executed through traders unrelated to the Company and the Manager. The investment advisory fee the County pays is all-inclusive.

We conclude that while the investment advisory fee includes brokerage and selling commissions, it also includes fees that are not permitted to be taken into account. The fee compensates the Manager and Company for very broad investment management services, more in the nature of portfolio management. While these services may be associated with the purchase or sale of investments, they are not directly connected to the buying and selling of investments.

Conclusion

Based on the foregoing analysis we conclude that the investment advisory fee paid by the County to the Company and the Manager for their investment management services is not a "direct administrative cost" which may be treated as a "qualified administrative cost" within the meaning of § 1.148-5(e)(2)(i).

Except as specifically ruled above, no opinion is expressed concerning this transaction under any provision of the Code or regulations thereunder. Specifically, no opinion is expressed concerning whether interest on the Bonds is excludable from gross income under § 103(a).

This ruling letter is addressed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By: ______________________
Rebecca L. Harrigal
Chief, Branch 5

Enclosure:
Copy for § 6110 purposes